> such comparative practices analyses, however, to some extent is mitigated by conditions that require the spread of best practices . . .

Id. ¶ 423. Of course, some of the conditions ostensibly sought to reach the anticompetitive aspects of the merger. In approving the merger notwithstanding its concerns, the Commission reasoned that some of the conditions would aid to open SWBT's local markets, and that local competition would serve as "the one sure remedy" for SWBT's threatened misconduct. Id. ¶ 230 (emphasis added). In other words, in approving the merger, the Commission recognized that it would now be that much more important to ensure that the market opening conditions of Section 271 are in fact met.

Because the risk of potential harm of BOC entry has increased, a substantial degree of confidence that the offsetting benefits to BOC entry is necessary before a positive public interest finding can reasonably be made. Sprint does not mean to suggest that SWBT should be held to a higher standard of proof than other BOCs. It does mean, however, that the Commission's assessment that a series of "smaller" problems, say in checklist provisioning or OSS, must be weighed in the context of this overall concern. In the New York Order, the Commission dismissed as not sufficiently significant evidence of problems in Bell Atlantic's checklist compliance. See New York Order ¶ 5 ("we consider the overall picture presented by the record, rather than focusing on any one aspect of performance"). Some of these

issues raised by opponents were dismissed because they were considered inconsequential alone, others were found insufficient to outweigh other evidence ostensibly demonstrating compliance. Because the local markets otherwise were found to have been opened, some degree of uncertainty was found tolerable. See id. ¶ 236 (failure to comply with federal obligations to provide UNEs pending litigation mitigated by Bell Atlantic's compliance with NYPSC rules in effect); id. ¶ 258 (uncertainty created by interim rather than permanent rates for UNEs may be tolerable in some cases and "should be addressed on a case-by-case basis"). Here, with the SBC/Ameritech merger complete, the balancing that was done for New York must now be undertaken in a different and more worrisome (from the public interest perspective) context.

Moreover, the distinction between New York and Texas is especially strong for xDSL. As discussed, SWBT's abuse of the discovery process during the Covad/Rhythms arbitration as a means of delaying xDSL competition provides an independent and sufficient basis for holding SWBT to the letter of the checklist law for xDSL. The rationale provided in the New York Order for the "nascent services" exception simply is not available in Texas.

Further, SWBT's expert witnesses are able to conclude that SWBT is unlikely to discriminate against competitive providers of toll service only by erroneously assuming that there were no competitive problems in other areas of RBOC integration, namely,

cellular and intraLATA toll. This is simply wrong. As Sprint has demonstrated previously, there is substantial evidence of RBOC misconduct in both of these areas. This evidence is submitted here as Appendix A.[56] As shown there, the facts surrounding intraLATA toll and cellular interconnection confirm the anticompetitive incentives and abilities of the RBOCs when vertically integrated into less regulated, competitive markets.

B. The Effects On The Local Markets Alone Dictate The Conclusion That Relief Would Be Contrary To The Public Interest.

As the Commission has recognized, the prospect of interLATA entry is the incentive given by Congress to a BOC to induce its cooperation in opening its local monopoly.[57] Absent this inducement, no BOC would rationally relinquish its bottleneck and voluntarily aid in bringing about competition.[58] The record does

---

[56] See Hayes, Jayaratne & Katz, "An Empirical Analysis Of The Footprint Effects of Mergers Between Large ILECs," at 18-21, attached to Ex Parte Letter from Willkie Farr & Gallagher, CC Dkt. Nos. 98-141 & 98-184 (filed Apr. 2, 1999) (attached as Appendix A). The ex parte letter with its attachments was submitted in the recent RBOC merger proceedings in response to arguments made by RBOC economists there that the experiences of cellular and intraLATA toll supposedly demonstrated that any discrimination problems are small and can be addressed adequately by regulatory safeguards. The SBC/Ameritech Order expressly rejected these RBOC arguments. SBC/Ameritech Order ¶ 206.

[57] See Michigan Order ¶ 23.

[58] As the FCC has found:

> incumbent LECs have no economic incentive, independent of the incentives set forth in sections 271 and 274 of the 1996 Act, to provide potential competitors with

not reflect that SWBT has fully lowered the entry barriers to its local markets such that its application can be determined to serve the public interest.

SWBT has not demonstrated that the Texas local markets have been irreversibly opened to competition. The amount of CLEC activity has been grossly inflated by SWBT. The magnitude of the misrepresentation is evident from the fact that SWBT's calculation of the number of competitively provisioned subscriber lines is more than two and one half times the PUCT's results, gained from the CLECs' self-reporting.[59] Whereas SWBT purports to show that there were over 1.3 million lines served by CLECs in October 1999, the PUCT estimated less than 500,000 lines served by CLECs in September 1999.

Even setting aside the far greater credibility of the PUCT and its significantly more reliable methods, there are some ready explanations for this discrepancy. SWBT's count plainly includes lines that are used in ways that bear no economic relevance to the ultimate question here: the degree of competition faced by SWBT in its local markets. Thus, SWBT has included lines used to

---

> opportunities to interconnect with and make use of the incumbent LEC's network and services.

Local Competition Order ¶ 55.

[59] See Memorandum to SWBT and 271 Participants, Aggregated Responses to Order Nos. 49, 56 and 57 (PUCT Nov. 12, 1999) (estimating the total number of access lines served by CLECs to be 489,632 in September 1999 -- recognizing that one or more companies did not provide a response).

serve ISPs, telemarketers and calling centers[60] -- all of which serve to inflate SWBT's final count without giving any credence to SWBT's claim that it faces substantial competition from CLECs for the provision of local exchange services.

Other fundamental flaws can be identified in SWBT's count. SWBT implemented a convoluted methodology for determining the number of customers its competitors are serving in Texas.[61] First, it multiplied the number of interconnection trunks by an estimate of 2.75 access lines per trunk. It then added the number of UNE loop/port combinations to the result to obtain a total number of facilities-based CLEC lines. Next, it categorized these subscribers into business and residential by applying a ratio calculated from the number of residential and business E911 listings. If the resulting number of lines for residential or business was zero, it adopted the E911 counts for that service. SWBT repeated this procedure separately for each individual CLEC.

SWBT offers no substantiation for its assumption that there are 2.75 access lines per interconnection trunk. By applying this multiple to the number of interconnection trunks (the only value of which SWBT can be sure), the result bears little resemblance to the actual number of access lines served by SWBT's

---

60 See Habeeb Aff. ¶ 25.

61 See id. ¶ 27.

competitors. Evidence adduced before the PUCT shows that the multiple is indeed wrong, and that newly established networks operate at much lower factors.[62] Unsurprisingly, then, numerous CLECs filed challenges to SWBT's subscriber estimates (using the same methodology) before the PUCT. Although SWBT claims that readjustments made after the CLEC complaints changed the totals by five percent, other miscalculations have overstated individual totals by as much as 40%.[63] In total, these miscalculations result in a vast overstatement of the degree of competitive activity in Texas.

Further, SWBT has not shown that significant numbers of residential customers in particular are or can be served by CLECs. SWBT's use of a ratio of residential to total lines in the E911 database most likely overstates by a wide margin the amount of residential competition in Texas.[64] SWBT calculated a ratio of residential-to-total listings that has the effect of inflating the number of residential customers because business lines may in fact be underrepresented in the E911 database. In the case of some businesses, only one "lead" phone number may be

---

62 See, e.g., 10/29/99 Hrg. Tr. at 74-75 (clarifying testimony of Stephen Turner); Turner 10/27/99 Aff. ¶¶ 23-27.

63 See, e.g., Habeeb Aff. ¶ 41 (ICG's actual subscribers 40% less than SWBT's estimates).

64 See, e.g., 10/29/99 Hrg. Tr. at 75 (clarifying testimony of Stephen Turner) (stating that it is debatable as to whether there is any facilities-based residential competition at all); Turner 10/27/99 Aff. ¶¶ 8-17.

listed to represent what could be a larger number of business lines.[65] More disconcerting, the number of facilities-based residential lines in each calling area can easily be determined directly from the E911 databases without any need for any extrapolation at all. In fact, SWBT admits that the number of "residential lines will likely be accurate by taking the E911 count."[66]

Upon review of the information found in SWBT's E911 database, the extent of the distortion caused by SWBT's convoluted methodology becomes readily apparent: the number of facilities-based residential E911 listings is a tiny fraction of the 73,619 facilities-based residential competitive access lines produced by SWBT's methodology.

While the Commission has been careful to not make it preclusive, the absence of actual competition "to different classes of customers (residential and business) through a variety of arrangements. . . in different geographic regions (urban, suburban, and rural) in the relevant state, and at different scales of operation (small and large)," see Michigan Order ¶ 391, has been identified as an important part of the public interest inquiry. The FCC must be able to assure the public that local competition benefits will be enjoyed throughout the state, and

---

[65] See, e.g., 10/29/99 Hrg. Tr. at 19-21 (cross-examination of John Habeeb).

[66] Habeeb Aff. ¶ 25.

not merely by the largest users, or small businesses fortunately located in areas of extraordinarily dense commerce.

The relevance of this failure of proof is highly significant; it distinguishes SWBT's application from the application for New York in two critical ways. First, it dispels SWBT's claims that its 271 application somehow surpasses that of Bell Atlantic in New York. See, e.g., Br., Attachment 2. Although the Commission has stated that there are no "magic numbers" that would open the door for long distance entry by an incumbent, see New York Order ¶¶ 426-27, SWBT relies heavily on this type of data to demonstrate that the Texas market is as competitive, if not more so, than the New York market. Any summary examination of SWBT's claims reveals this is simply not the case.

Second, and more importantly, the Commission saw fit to dismiss or discount CLEC problems in New York because, in large part, the overall "market context" demonstrated a significant amount of CLEC presence even in the face of these problems. See id. ¶¶ 13-15, 426-27. The Commission expressed its confidence in moving from "predictive judgments" to observing "market facts" and this circumstance gave the Commission far greater confidence that problems could be solved and did not overwhelm the overall showing of compliance. This crucial factor is absent here: notwithstanding SWBT's claims, its market facts regarding CLEC

activity fall dramatically short of the demonstration made by Bell Atlantic in New York.

C. The Effects On The InterLATA Market Also Require Denial Of The Application.

SWBT also recycles the standard factual misrepresentations about competition in the interLATA markets. The Commission has already determined that BOC entry into these markets will be beneficial to consumers but only when local markets have been opened. As the Commission has explained,

> Section 271, however, embodies a congressional determination that, in order for this potential to become a reality, local telecommunications markets must first be open to competition so that a BOC cannot use its control over bottleneck local exchange facilities to undermine competition in the long distance market. Only then is the other congressional intention of creating an incentive or reward for opening the local exchange market met.

Michigan Order ¶ 388; see New York Order ¶ 428 ("BOC entry into the long distance market will benefit consumers and competition if the relevant market is open to competition consistent with the competitive checklist").

In any event, the Commission has repeatedly found long distance markets to be competitive. See, e.g., WorldCom, Inc. and MCI Communications Corp., 13 FCC Rcd. 18025 (1998); Global Crossing Ltd. and Frontier Corp., CC Dkt. No. 99-264, 1999 FCC LEXIS 4621, ¶ 18 (rel. Sept. 21, 1999). Long distance telecommunications services have been characterized by increasing supply, dramatic rates of innovation, ever-increasing demand, and

constantly declining prices. And while SWBT's experts repeat their counterfactual claims regarding the relative states of competition in the local and long distance markets, Chairman Kennard testified last year before Congress that between 1992 and 1997, long distance rates fell by 24% or, in absolute terms, twice the amount of access charge reductions. See "A New FCC for the 21st Century," Chart 4 (Mar. 17, 1999). The predicted trends for long distance promise to continue to promote consumer welfare. See Fiber Deployment Update, End of Year 1998, Table 1 (Sept. 1999) (reporting dramatic increases in U.S. fiber capacity; estimating annual increases of 30%).

However, if SWBT is allowed into long distance before being required to open its local markets, then competition would be harmed by BOC entry because "the BOC would have a unique ability to introduce vertical service packages (i.e., long distance and other telecommunications services bundled with local exchange service)." New York Order ¶ 428. Moreover, without adequate competition established at the local exchange level, there will be no market disciplining effect on SWBT to refrain from anticompetitive conduct in its provision of monopoly inputs for the interLATA market. Notwithstanding certain regulatory reforms, the Commission has readily expressed its concerns that both discrimination[67] and cross-subsidization[68] remain serious

---

[67] See SBC/Ameritech Order ¶ 228 (recognizing increased ability to discriminate notwithstanding regulatory safeguards intended to reduce discrimination); Joseph Farrell, Creating

threats to the interLATA competitive market. Further, the Commission's structural and accounting safeguards do not eliminate the opportunity to act on the incentives created by rate regulation. The Commission explicitly acknowledged in its Non-Accounting Safeguards Order that its rules leave BOCs with opportunities to misallocate the costs of their Section 272 affiliates.[69]

Local Competition, 49 Fed. Comm. L.J. 201, 207-08 (Nov. 1996) ("These problems [i.e., BOCs' incentives and ability to discriminate] are hard to regulate away, because the withdrawal of cooperation from rivals may be subtle, shifting, and temporary, but yet have real and permanent effects. . . .").

[68] See Amendment of the Commission's Rules to Establish Competitive Service Safeguards for Local Exchange Carrier Provision of Commercial Mobile Radio Services; Implementation of Section 601(d) of the Telecommunications Act of 1996, 12 FCC Rcd. 15668, ¶ 60 (1997) (the recent revision of the FCC's price cap rules "substantially reduces, but does not eliminate entirely the BOC's incentive to misallocate costs, since the price caps regime still retains a rate-of-return aspect in the low-end adjustment mechanism. Furthermore, periodic performance reviews to update the X-factor could replicate the effects of rate-of-return regulation, if based on a particular carrier's interstate earnings rather than industry-wide productivity growth.") (citations omitted); see also National Rural Telecom Ass'n v. FCC, 988 F.2d 174, 178 (D.C. Cir. 1993) ("price cap regulation cannot quite live up to its promise").

[69] In establishing the structural safeguards applicable to BOC Section 272 affiliates, the Commission balanced the inefficient incentives with the increased economies of scale and scope created by the integration of BOCs and their affiliates. Implementation of the Non-Accounting Safeguards of Sections 271 and 272, 11 FCC Rcd. 21905, ¶ 167 (1996). In permitting substantial integration, for example, sharing of marketing and administrative services and the offices and equipment associated with those activities, the Commission stated that "[w]e recognize that allowing the sharing of in-

Additionally, substantial harm to the interLATA markets prior to full implementation of access reform is threatened. Competition cannot produce the hoped for efficiency gains for consumers if regulation continues to distort the market. The inflated access charges that Sprint and other IXCs must pay over to SWBT and to other BOCs create indisputable problems if they are allowed to compete for interLATA business. Unless access reform is achieved prior to long distance authority, the Bell Companies will be at an insurmountable (but artificial) advantage, being able to force their very competitors in long distance to subsidize BOC operations. This advantage is not derived from any scope economies, but through regulatory distortions. SWBT has a clear, artificial cost advantage in obtaining the access services essential to the provision of interLATA services.[70]

---

house services will require a BOC to allocate the costs of such services between the operating company and its section 272 affiliate and provide opportunities for improper cost allocation . . . ." Id. ¶ 180. Undetected cross-subsidy is therefore a recognized risk despite regulatory safeguards.

[70] SWBT will be able to compete for incremental toll calling by imputing the true cost of access; everyone else will be competitively disadvantaged by the need to include the inflated access costs charged by SWBT. This advantage is by no means rectified by regulatory requirements of separate subsidiaries and imputation, since economic judgments will be made for the enterprise as a whole.

D. The Commission's Public Interest Inquiry Appropriately Includes The Substantial Evidence Of Repeated Misconduct By SWBT Against CLECs.

As the Commission stated in the Michigan Order:

> Furthermore, we would be interested in evidence that a BOC applicant has engaged in discriminatory or other anticompetitive conduct, or failed to comply with state and federal telecommunications regulations. Because the success of the market opening provisions of the 1996 Act depend, to a large extent, on the cooperation of incumbent LECs, including the BOCs, with new entrants and good faith compliance by such LECs with their statutory obligations, evidence that a BOC has engaged in a pattern of discriminatory conduct or disobeying federal and state telecommunications regulations would tend to undermine our confidence that the BOC's local market is, or will remain, open to competition once the BOC has received interLATA authority.[71]

In the New York Order, the Commission dismissed complaints regarding Bell Atlantic's lack of cooperation because the record did not reflect systematic or widespread failures. But that is precisely what is in evidence here. The dissatisfaction with SWBT's performance cuts across CLECs, across issues, across SWBT's region. These complaints are too numerous to ignore.

SWBT's own course of conduct highlights the public interest harms of premature entry here. First, SWBT has already acted in ways inconsistent with its legal obligations under Sections 271 and 272 of the Act and has paid more than $1 million in fines for these acts. See SBC Communications Inc., FCC 99-153 (rel. June 28, 1999) (settlement agreement regarding violations stemming

---

[71] Michigan Order ¶ 397.

from SNET merger). Second, SWBT's intransigence in complying with its legal obligations under Sections 251 and 252 of the Act has been documented by other legal authorities, including the PUCT at an earlier stage of the 271 proceedings[72] and by a federal district court.[73]

Moreover, as discussed, SWBT engaged in blatant delay tactics to avoid providing nondiscriminatory access to xDSL loops and loop information as well as to LIDB ordering functionalities.

---

[72] Overall, "SWBT needs to change its corporate attitude and view [its competitors] as wholesale customers . . . . SWBT needs to show this Commission and participants during the collaborative process by its actions that its corporate attitude has changed and that it has begun to treat CLECs like its customers." Order No. 25 Adopting Staff Recommendations; Directing Staff to Establish Colloborative Process, Attachment 1 at 2 (PUCT June 1, 1998).

[73] "The undersigned must note, however, that it was somewhat troubled by SWBT tactics in this case. SWBT's penchant for rehashing issues that had already been fully briefed, raising arguments and claims that did not appear in even the most generous reading of the Amended Complaint, and, most importantly, taking positions in this litigation that it had expressly disavowed in the PUC administrative hearing, were, to say the least, distressing. The voluminous briefing in this case--over seven hundred pages in total--could probably have been cut in half had SWBT not fought tooth and nail for every single obviously non-meritorious point. Suffice it to say that every conceivable objection SWBT could have raised to the interconnection agreements was, in fact, raised here and fully briefed by all parties to the lawsuit. The Court has considered these arguments and has concluded that the arbitrated terms of the interconnection agreements fully comply with the requirements of §§ 251 and 252 of the FTA and that the PUC's decisions regarding those arbitrated terms did not involve a misinterpretation or misapplication of federal law and were not arbitrary and capricious." Southwestern Bell v. AT&T Communications of the Southwest, No. A97-CA-132 SS, 1998 U.S. Dist. LEXIS 15637, at **56-57 (W.D. Tex. Aug. 31, 1998).

In both cases, SWBT's legal obligation under the Section 271 checklist to cooperate with CLECs should not have been in dispute, and yet in both cases SWBT flouted its obligations under the 1996 Act as well as state law. Slow rolling delay tactics do not get much more transparent than these, and yet SWBT was willing to engage in them while it was pursuing the Section 271 process in Texas.

SWBT will no doubt respond with the fact that these problems have in one way or another been resolved. That is in fact the case with some aspects of these issues, although in neither case is resolution complete. But for purposes of the public interest inquiry, the more important question is why did they arise in the first instance, and whether their resolution gives any confidence that the recidivism will not continue. The very unfortunate answer is no. Indeed there are several issues for which SWBT has proposed "resolutions" during the last several months, at a time when SWBT rather suddenly decided to change at least some of its anticompetitive positions once it finally reconciled itself to the fact that Section 271 relief would in fact need to be earned on the merits. For example, SWBT only recently agreed to increase the financial penalties for failure to meet performance benchmarks to a level that is comparable to penalties applicable in New York. As mentioned, SWBT has also committed to broad range services to offset its poor performance in providing xDSL-capable loops. These acts of volition were welcome, but what

realistic chance is there that these problems won't reappear, either in their old form or new ones, if SWBT is granted its request without adequate compliance measures firmly in place?

CONCLUSION

For the foregoing reasons, SWBT's application must be denied.

Respectfully submitted,

Sprint Communications Company L.P.

Leon M. Kestenbaum
Vice President, Federal
Regulatory Affairs
SPRINT COMMUNICATIONS COMPANY L.P.
401 Ninth St., N.W.
Suite 400
Washington, D.C. 20004
(202) 585-1900

Philip L. Verveer
Sue D. Blumenfeld
Thomas Jones
Renee Callahan
Angie Kronenberg
David Don

WILLKIE FARR & GALLAGHER
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20036
(202) 328-8000

ITS ATTORNEYS

Dated: January 31, 2000

WILLKIE FARR & GALLAGHER

Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20036-3384

202 328 8000
Fax: 202 887 8979

April 2, 1999 **EX PARTE**

Ms. Magalie Roman Salas
Office of the Secretary
Federal Communications Commission
The Portals. 445 Twelfth Street, S.W.
Washington, D.C. 20554

Re: SBC Communications Inc. and Ameritech Corporation (CC Dkt. No. 98-141) and GTE Corporation and Bell Atlantic Corporation (CC Dkt. No. 98-184)

Dear Ms. Salas:

Sprint Communications Company L.P., by its attorneys, submits the enclosed paper entitled "An Empirical Analysis of the Footprint Effects of Mergers Between Large ILECs" in response to numerous ex parte presentations and statements made during the Commission's February 5, 1999 "Roundtable on the Economics of Mergers between Large ILECs." This paper was prepared by John Hayes, Jith Jayaratne, and Michael Katz and discusses empirical evidence supporting the "big footprint" theory. The paper confirms that the proposed SBC-Ameritech and Bell Atlantic-GTE mergers will harm competition in local exchange, interexchange, and combined-services markets due to the effects of the big footprint.

Two legal memoranda are also attached in support of the footprint effects analysis: (1) "LEC-Cellular Interconnection: Historical Analysis" and (2) "Post-merger Examples of the Spread of Degraded Practices in the Acquired BOC's Territory and Worsening Conditions in the Acquiring BOC's Territory." The first memorandum examines the history of substantial delays and other difficulties in independent cellular carriers' efforts to interconnect to local exchange carriers. As the Commission is aware, this issue has been the subject of recent discussion in the above-referenced merger proceedings, both at the FCC's "Roundtable on the Economics of Mergers between Large ILECs"[1] and in the declaration of Robert W. Crandall and J. Gregory Sidak submitted in the FCC's GTE Corporation

[1] See Round Table on the Economics of Mergers between Large ILECs, CC Dkt. No. 98-141, Transcript at 130 (Feb. 5, 1999) (statement of Robert Crandall, Brookings Institute).

and Bell Atlantic Corporation merger proceeding.[2] This paper demonstrates that the merger proponents profoundly misapprehend the LEC-cellular interconnection history. The subject of this paper is limited to the controversies that surrounded physical interconnection. The controversies surrounding prices LECs charged for interconnection persisted well beyond the resolution of the physical interconnection problems.[3]

The second memorandum offers anecdotal evidence of the anticompetitive effects of the SBC/Pacific Telesis and Bell Atlantic/NYNEX mergers, as demonstrated by comparisons of pre-merger and post-merger practices. These anecdotes compare both the *acquired* BOCs' business practices pre-merger to their practices post-merger as well the *acquiring* BOCs' business practices pre- and post-merger. As expected, not only do the post-merger comparisons reveal a spread of degraded practices from the acquiring BOC to the acquired BOC, but they also demonstrate, as predicted by the big footprint analysis, a worsening of conditions in the acquiring BOCs' existing territories.

---

[2] See Declaration of Robert W. Crandall and J. Gregory Sidak ¶ 31, submitted as an attachment to the *Joint Reply of Bell Atlantic Corp. and GTE Corp. to Petition to Deny and Comments*, in GTE Corp. and Bell Atlantic Corp., For Consent to Transfer of Control, CC Dkt. No. 98-184 (filed Dec. 23, 1998) ("We know of no evidence that ILECs have attempted to degrade the wireline interconnection of their local wireless competitors. Nor are we aware that the ILECs have been able to gain a competitive advantage over their unintegrated wireless rivals.").

[3] See, e.g., Implementation of the Local Competition Provisions in the Telecommunications Act of 1996; Interconnection between Local Exchange Carriers and Commercial Mobile Radio Service Providers, CC Dkt. Nos. 96-98 and 95-185, *First Report and Order*, 11 FCC Rcd. 15499 (1996); Interconnection Between Local Exchange Carriers and Commercial Mobile Service Providers; Equal Access and Interconnection Obligations Pertaining to Commercial Mobile Radio Service Providers, CC Dkt. Nos. 95-185, *Notice of Proposed Rulemaking*, 11 FCC Rcd. 5020 (1996). We would be happy to prepare a separate submission on the subject of interconnection or settlement charges if the Commission would find that useful, or to address any of the matters discussed in this memorandum at greater length.

We are filing the original and one copy of this letter, in accordance with the Commission's rules. Please let me know if you have any questions. I can be reached at 202-429-4787.

Sincerely,

Michael Jones

Enclosures

cc: Lawrence Strickling
Carol Mattey
To-Quyen Truong
Michael Kende
Radhika Karmarkar
William Dever
Janice Myles

AN EMPIRICAL ANALYSIS OF THE FOOTPRINT EFFECTS OF MERGERS BETWEEN LARGE ILECS

John B. Hayes, Jith Jayaratne, and Michael L. Katz

1 April 1999

TABLE OF CONTENTS

I. INTRODUCTION

1. This report reviews, in summary form, the empirical evidence that the proposed SBC-Ameritech and Bell Atlantic-GTE mergers will harm competition in local exchange, interexchange, and combined-service markets due to footprint effects.[1] The economic logic of competitive spillovers implies that the increase in ILEC footprints resulting from these proposed mergers would increase the ILECs' incentives to disadvantage rivals by degrading access services they need to compete, thereby harming competition and consumers.[2]

2. A review of the evidence available to us, supports three conclusions:

- ILEC claims to the contrary notwithstanding, experience in cellular and intraLATA markets supports the footprint theory. Experience in interLATA and local exchange markets also is consistent with the footprint theory.
- There is evidence that the provision of access services to competitors deteriorated following previous RBOC mergers. Such direct evidence of footprint effects is, however, limited at this time because the previous RBOC mergers were only recently completed and because the current proposed mergers create substantially larger footprints than previous mergers.
- Most important, there is sound logical and empirical support for the proposition that the proposed mergers will give rise to substantial footprint effects in the future. As we discuss below, this support can be seen in the evidence for each step in the economic logic leading to the conclusion that the proposed ILEC mergers threaten competition.

---

[1] We have prepared this report as part of our ongoing analysis of the large ILEC mergers on behalf of Sprint in the matter of Ameritech Corp. and SBC Communications, Inc., For Consent to Transfer Control, CC Dkt. No. 98-141, and in the matter of GTE Corporation and Bell Atlantic Corporation, For Consent to Transfer of Control, CC Dkt. No. 98-184. In particular, several of the issues addressed here are responsive to points raised at the 5 February 1999 *FCC Roundtable on the Economics of Mergers between Large ILECs.*

[2] See Declaration of Michael L. Katz and Steven C. Salop, submitted as an attachment to *Petition to Deny of Sprint Communications Company L.P.* in Ameritech Corp. and SBC Communications, Inc., For Consent to Transfer Control, CC Dkt. No. 98-141 (filed Oct. 15, 1998). The analysis of the Declaration was affirmed by the authors for submission in *Petition to Deny of Sprint Communications Company L.P.* in GTE Corporation and Bell Atlantic Corporation, For Consent to Transfer of Control, CC Dkt. No. 98-184 (filed Nov. 23, 1998).

3. Before reviewing the evidence on footprint effects, it is useful to summarize the logic of footprint effects. ILECs possess market power in the provision of access services, and rival competitive local exchange carriers (CLECs), interexchange carriers (IXCs), and combined service carriers (CSCs) depend on these services to compete. When an ILECs' margins on retail services exceed its margins on access services, the carrier has incentives to degrade access services provided to retail competitors if such degradation shifts retail demand to the ILEC. The incentives and abilities of ILECs to degrade access increases when they merge. For instance, exclusionary activity by SBC benefits Ameritech in two ways. First, such activity reduces the return on investments by national local exchange competitors (including combined service competitors). In response, these competitors will scale back or eliminate investments, including investments that are nationwide in their benefits (*e.g.*, R&D and systems development), thereby weakening these firms in Ameritech regions. Second, SBC can shift customers to Ameritech by degrading the terminating access of calls that are originated by interexchange carriers (again, including combined service carriers) from Ameritech regions. The proposed merger would cause SBC to internalize these anticompetitive spillovers and therefore would increase SBC's incentives to engage in such activities. In the light of the inherent limitations of regulation—especially for new types of access and interconnection—the increased incentives and abilities will result in tangible harm to competition and consumers.

4. Basic economic reasoning confirms the importance of the footprint effect. A critical question for policy makers, of course, is whether there is evidence to support the conclusion that footprint effects are large. We believe there is such evidence, and the remainder of this

memorandum reviews several different types of information supporting the existence of substantial footprint effects.

- The parties to the proposed mergers argue that evidence from intraLATA toll and cellular markets establishes that ILECs do not block competition even when they would internalize a high percentage of the benefits from doing so.[3] The parties further assert that exclusionary behavior by ILECs is, in general, not a problem. As we show below, however, the historical evidence in intraLATA and cellular markets shows clearly that ILECs have in fact obstructed competition in these markets. Even when their actions did not completely deter entry, their behavior substantially delayed or weakened competition, to the detriment of consumers. Evidence from local exchange and interLATA markets also is consistent with footprint effects.
- Another approach to assessing footprint effects is to examine past mergers among large ILECs for evidence of increased exclusionary behavior following these mergers. The merging parties have argued, for example, that entry into California increased after the SBC-Pacific Bell merger and that this entry pattern is inconsistent with increased exclusionary behavior following the merger.[4] Their analysis, however, is critically flawed because it fails to account for the nationwide trend toward increased CLEC entry. Once one accounts for this trend, entry into California appears to have slowed rather than accelerated after the SBC-Pacific Bell merger. Moreover, there are many instances in which rival carriers have complained of poorer access services following the SBC-Pacific Bell and Bell Atlantic-NYNEX mergers.
- Cross-sectional comparisons of entry into large and small ILEC regions provide a third source of historical evidence regarding footprint effects. Economic theory predicts that large ILECs will experience less entry because they have greater incentives to exclude than small ILECs. Our analysis of CLEC entry reveals evidence in support of this prediction: large ILECs are shown to have experienced less entry.
- It is important to recognize that the historical evidence is likely to underestimate footprint effects from the proposed mergers for several reasons. First, very recent and future changes in regulation and technology will create more head-to-head competition between ILECs and carriers who purchase access and interconnection from them than has been experienced at any time in the past, thereby intensifying the ILECs' incentives to exclude rivals. Second, an ILEC's ability to exclude rivals may increase qualitatively as its size

---

[3] See, for example, the comments of Dennis Carlton, transcript of *FCC Roundtable on the Economics of Mergers between Large ILECs*, CC Dkt. No. 98-141, 5 February 1999, p. 130.

[4] Reply Affidavit of Richard Gilbert and Robert Harris ¶ 68, submitted as an attachment to the *Joint Opposition of SBC Communications Inc. and Ameritech Corp. to Petitions to Deny and Reply to Comments*, in Ameritech Corp. and SBC Communications, Inc., For Consent to the Transfer of Control of Licenses and Section 214 Authorization, CC Dkt. No. 98-141 (filed November 16, 1998).